

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to:

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subject: IDC Preference Computation

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

**ISSUE**

How is the intangible drilling cost (IDC) preference exception under § 57(a)(2)(E) of the Internal Revenue Code computed for a taxpayer that is not an integrated oil company (as defined in § 291(b)(4)) and that has negative alternative minimum taxable income for the taxable year?

**CONCLUSION**

The IDC preference exception under § 57(a)(2)(E) does not apply to taxpayers with negative alternative minimum taxable income for the taxable year.

**FACTS**

In 2012, IP has alternative minimum taxable income (AMTI) of negative \$100, prior to inclusion of its IDC preference. IP has an IDC preference of \$80, which will increase AMTI to negative \$20 if required to be taken into account by IP. IP is not an integrated oil company as defined in § 291(b)(4) and thus contends that it gets the benefit of the

IDC preference exception provided in § 57(a)(2)(E). IP thus reports AMTI for the taxable year of negative \$100.

### LAW AND ANALYSIS

Section 55 imposes an alternative minimum tax (AMT) equal to the excess (if any) of the tentative minimum tax (TMT) for the taxable year, over the regular tax for the taxable year. The TMT equals the AMT rate applied to the excess of AMTI for the taxable year over an exemption amount, reduced by the AMT foreign tax credit for the taxable year.

Section 55(b)(2) defines AMTI as the taxable income of the taxpayer for the taxable year, determined with the adjustments provided in §§ 56 and 58, and increased by the items of tax preference provided in § 57.

Section 57(a)(2) requires taxpayers to include the IDC preference in their AMTI. In general, the IDC preference is, for each oil, gas and geothermal property of the taxpayer, the amount by which the taxpayer's excess IDCs arising in the taxable year exceed 65 percent of the taxpayer's net income from oil, gas and geothermal properties for the taxable year. Under § 57(a)(2)(E)(i), non-integrated oil companies, as defined in § 291(b)(4), may ignore all or a portion of their IDC preference in computing AMTI (the IDC preference exception). The reduction in AMTI by reason of the IDC preference exception for any taxable year may not exceed 40 percent of the AMTI for the year determined without regard to IDC preference exception. See § 57(a)(2)(E)(ii).

The Senate Finance Committee Explanation for the IDC preference exception is as follows: "The committee believes the effectiveness of oil and gas incentives for domestic drilling and production is reduced to the extent that taxpayers in the oil and gas industry are subject to the AMT. Consequently, to increase the effectiveness of certain oil and gas incentives, the committee desires to make these incentives generally applicable to the AMT." S. Prt No. 102-95 at 14-15 (1992).

The following examples demonstrate the application of the IDC preference exception:

Example 1: Taxpayer A, prior to applying the IDC preference exception, has AMTI of \$350, which includes an IDC preference of \$150. A is not an integrated oil company. As noted above, A may use the IDC preference exception to reduce AMTI by 40 percent of the AMTI for the year determined without regard to the IDC preference exception. A can thus reduce its AMTI by \$140 ( $\$350 \times .40$ ). A's AMTI for the year is \$210 (\$350 minus the IDC preference exception reduction of \$140).

Example 2: Taxpayer B, also a non-integrated oil company, has AMTI of \$0, which includes an IDC preference of \$150. B cannot reduce its AMTI by applying the IDC preference exception because B is limited to a 40 percent reduction of AMTI determined without regard to the IDC preference exception, and 40 percent of \$0 is \$0.

In the present case, IP, prior to applying the IDC preference exception, has AMTI of negative \$20, which includes an IDC preference of \$80. IP contends that the 40 percent AMTI reduction limitation in § 57(a)(2)(E)(ii) does not apply when a taxpayer has negative AMTI and that its AMTI is negative \$100. We disagree with that position.

Because the IDC preference exception is limited to 40 percent of AMTI, the benefit a taxpayer derives from the AMT IDC exception is reduced as the taxpayer's AMTI decreases. A taxpayer with \$350 of AMTI (before applying the IDC preference exception) is allowed an AMTI reduction of \$140 (Example 1 above), while a taxpayer with AMTI of \$100 may reduce AMTI by only \$40. Finally, a taxpayer with \$0 of AMTI gets no benefit from applying § 57(a)(2)(E) (Example 2 above). Recognizing that taxpayers with \$0 of AMTI cannot use the IDC preference exception to reduce AMTI and create an AMT net operating loss, we can think of no reason why a taxpayer with negative AMTI should be permitted to use the exception to increase its AMT net operating loss. Neither taxpayer owes AMT for the taxable year and thus neither are taxpayers for which Congress was seeking AMT relief when it enacted § 57(a)(2)(E). Congress's intent in enacting § 57(a)(2)(E) was to restore the effectiveness of certain oil and gas incentives for non-integrated oil companies subject to the AMT. A taxpayer with AMTI of \$0 or negative AMTI will not have an AMT liability, is not subject to AMT, and thus is not in need of AMT relief. Consequently, as in the case of taxpayers with \$0 of AMTI, taxpayers with negative AMTI cannot apply § 57(a)(2)(E) to reduce their AMTI.

Further, applying the exception to taxpayers with negative AMTI results in an increase to AMTI, which is a result not contemplated by Congress. Under § 57(a)(2)(E)(ii), the reduction in AMTI by reason of the IDC preference exception may not exceed 40 percent of the AMTI for the year (determined without regard to the IDC preference exception). The limitation is computed by multiplying the AMTI (before applying the IDC preference exception) by 40 percent. The taxpayer's AMTI is then reduced by the 40 percent amount (unless the IDC preference is actually smaller than that amount, in which case AMTI is reduced to the extent of the IDC preference).

IP's AMTI for the year (without the IDC preference exception) is negative \$20. Applying § 57(a)(2)(E) to IP would result in an AMTI of negative \$12 (an increase of \$8), computed as follows: negative \$20 times 40 percent is negative \$8 (meaning that IP's AMTI cannot be reduced by more than negative \$8). Continuing with the computation, negative \$20 minus negative \$8 is negative \$12 because  $-\$20 \text{ minus } -\$8 \text{ equals } -\$20 + \$8$ . Thus, a literal application of § 57(a)(2)(E) to taxpayers with negative AMTI results in an increase to AMTI, which further supports the position that § 57(a)(2)(E) does not apply to taxpayers with negative AMTI.

Please call Steve Toomey at (202) 622-4920 if you have any further questions.